THE ILLINOIS BLUE SKY LAW

The passage of the Illinois Securities Law, June 11, 1919, marks the advent of a new principle in American effort to solve the problem of misrepresentation and fraud in the handling of securities—the principle of classification. At the same time it represents an attempt to approach the problem from a somewhat new angle. Previous to the passage of the act, the thirty-nine states which had enacted blue sky legislation had largely contented themselves with supervising, in rather half-hearted fashion, merely the dealers themselves. This they had attempted to accomplish by various systems of inspection and through the exercise of a modicum of discretionary executive control in the granting of licenses. Illinois itself had such an act, passed in 1918. Taken as a whole, these measures were far from effective. In the first place the wide variations between the laws of the several states left many loopholes for evasion and fraud;[1] and in the second place the laws all approached the problem from its most complex and difficult side. The new Illinois law, however, attempts to remedy this second difficulty. It considers not only the dealers but also the issuers of the securities, and makes them to some extent responsible for compliance with the law. England has for many years had an effective law of this general type, designed primarily to enforce publicity, and Illinois has followed a part at least of its provisions.

In general terms, classification simply means that the government arbitrarily divides the securities handled within its jurisdiction into various broadly defined groups, basing the division largely on the speculative or non-speculative character of the securities themselves. Having done this, it then contents itself with the

[1] For example, the Illinois law now requires that if any securities are issued against intangible assets—patent rights, good-will, promoters' fees, etc.—this fact must be declared and the securities delivered in trust under an escrow agreement (see below). This provision is unknown in most states; and if a corporation wishes for any reason to escape it and still sell its securities, it has the whole United States, except Illinois, as a market.

effort to make sure that the purchaser knows beyond mistake into what particular group his proposed investment falls. The government's function is thus essentially that of information; it makes no attempt to restrict the sale of even the most doubtful and highly speculative security, provided that there is no actual evidence of fraud and that the speculative character of the investment has been adequately presented to the public.

The Illinois act is quite long, and to the layman not over-lucid. Its general scheme and main provisions can perhaps be most clearly presented in the form of a summarized outline. For the purposes of the act, securities are divided into four classes, alphabetically designated:

A. Securities, the inherent qualities of which ensure their sale and disposition without fraud. Within this group are included:
   1. Securities issued by a government or governmental agency.
   2. Securities issued by any national or state bank or trust company, building or loan association, or insurance company of the state.
   3. Securities issued by any corporation operating any public utility, in any state where the issues of such utilities are regulated by law.
   4. Securities dealt in on the New York, Chicago, Boston, Baltimore, Philadelphia, Pittsburgh, or Detroit stock exchanges.
   5. Securities whose prices have been quoted from time to time for at least a year in tabulated market reports published as news items, and not as advertising, in a daily newspaper of general circulation, published in Illinois or an adjoining state, including Michigan.
   6. Securities issued by any corporation organized for non-profit-making purposes.

B. Securities, where the inherent qualities are such or the nature of one or both parties to the sale thereof such that their sale and disposition without fraud are assured. This comprises the following types of securities:
   1. Those sold by the owner for the owner's account exclusively, when not in the course of continued and repeated transactions of a similar nature.
   2. Increased capital stock of a corporation, distributed directly among its stockholders, without the payment of any commission or expense to agents, brokers, etc.
   3. Those sold by or to any bank, trust company, or insurance company or association, organized under the laws of Illinois, of the United States, or under the supervision of the Department of Trade and Commerce or the Auditor of Public Accounts of Illinois; or by or to any building or loan association of the state; or any public sinking fund, trustees, or to any corporation or dealer or broker in securities.

4. Those sold or offered for sale at any judicial, executor's, or administrator's sale or any bankruptcy or public sale or auction held at any advertised time or place.

C. Securities based on an established income. This class includes the securities issued by any business which has been in continuous operation not less than two years and which has shown net profits, exclusive of all prior charges, as follows:
1. One and one-half times the annual interest charges upon all outstanding interest-bearing obligations.
2. In the case of preferred stock, not less than one and one-half times the annual dividend.
3. In the case of common stock, not less than 3 per cent per annum.[1]

D. All securities not falling within classes A, B, and C.

The main provisions of the law may be summarized as follows:

I. Provisions governing the offer of securities for sale:

Securities in Classes A and B are exempt from the provisions of the Blue Sky Law.

Securities in Class C may be sold only after filing a sworn statement in the office of the Secretary of State describing the securities to be sold, stating the law under which, and the time when, the corporation or business was organized, giving a balance sheet of assets and liabilities, an income or profit-and-loss statement, and an analysis of the surplus account, together with the names and addresses of its principal officers, directors, or trustees and other pertinent facts, data, and information, establishing the character of such securities.[2]

Before any Class D securities may be offered for sale, there must be filed, in the office of the Secretary of State, statements and documents as follows:

1. A description and the amount of the securities intended to be offered for sale.

[1] An administrative ruling states that "in the case of common stock with no par value, the maximum figure shown by either book value, market price, or the price fixed for sale to the public shall be the basis for computation."

[2] These provisions allowed the Secretary considerable administrative latitude, and at first he demanded very elaborate and detailed statements, inventories, and accounts for qualifications. A great deal of unnecessary annoyance and expense resulted. On November 8, 1919, a new ruling was issued which greatly simplified the requirements, by permitting the filing of sworn summaries instead of detailed schedules.

2. If the issuer is a corporation, a certified copy of the charter or articles of incorporation and by-laws.

3. If the issuer is a firm, trust, partnership, or unincorporated association, a copy of the articles of partnership, association, or trust agreement.

4. The names, addresses, and prior occupations during a period of not less than ten years prior to filing such statement (giving details as to time, place, and address of employer and reasons for discontinuance of employment) of the officers, directors, or trustees of the issuer, if it be a corporation, or of the persons composing the issuer, if the issuer be a non-incorporated association.

5. A description of the nature of the industry engaged in or intended to be engaged in and the approximate time when such industry was or will be established.

6. An inventory showing the assets of the issuer.

7. An appraisement of the assets of the issuer.

8. A statement in detail of the gross income of the issuer and the source or sources thereof, and of its operating and other expenses, for a period of twelve months prior to the date of filing such statement; or for the period of the existence of the issuer if less than two years prior to the date of filing.

9. A copy of the most recent balance sheet of the issuer, showing the financial condition of the issuer at a date not more than thirty days prior to the date of filing, and giving an analysis of surplus account from inception of such issuer.

10. A copy of the mortgage, trust deed, indenture, or writing securing the securities, whereunder the same are issued, if any such instruments there be.

11. A copy of the form of the securities intended to be offered.

12. A copy of any and all subscription blanks to be used in the sale thereof, which subscription blanks shall have printed thereon, "These are speculative securities."

13. A statement as to the manner in which the securities are to be offered and sold.

At any time, either before or after the filing of such statements, the Secretary of State may designate a certified public accountant

to make an examination of the books, records, and documents of the issuer, and make a report thereof.

If the statement discloses that any of such securities are intended to be issued for any patent right, copyright, trade-mark, process, or good-will, or for promotion fees or expenses, or for other intangible assets, the amount and nature thereof should be fully set forth and the securities issued in payment therefor should be delivered in escrow to a bank or trust company designated by the Secretary of State, under an escrow agreement that the owners of such securities shall in the case of dissolution or insolvency not participate in the assets of the corporation until after the owners of all other securities have been paid in full.

In case any statement or document filed in the office of the Secretary of State shall in his judgment be inadequate or not in compliance with the act, or in case the plan disclosed by such documents would in his judgment tend to work a fraud upon the people, or if it appears that the documents are false in any material particular, the Secretary of State shall apply for an injunction to restrain the further sale of such securities.[1]

II. Provisions affecting dealers in securities:

When Class D securities are to be sold through a solicitor, agent, or broker, a statement must be rendered giving the names, residences, qualifications, occupations, and business experience of such solicitor, agent, or broker for the preceding ten years. The signatures of each and every solicitor, agent, or broker shall be attached to such statement.

Any dealer, or owner, may sell Class D securities only after filing in the office of the Secretary of State a statement of the amount and description of the securities to be sold by him, the maximum price for which they are to be sold, and giving his address by street and number, qualifications, occupations, and business experience for the preceding ten years.

An irrevocable contract must be executed by such solicitor, agent, and broker authorized to offer or sell such securities, to the effect that the issuer will receive in cash not less than 80 per cent

[1] Section 24.

of the proceeds of the sale of the securities without liability for any further expenses or commission.

So long as any security continues to be offered for sale, new and supplementary statements must be filed at the expiration of each six months' period, showing (1) the amount of securities sold, sale price, the amount of cash proceeds received therefor, (2) all changes in the financial conditions of the issuer or in its management or property, accompanied by a copy of the most recent balance sheet, which must be not more than thirty days prior to the date of filing.

Each financial statement, prospectus, advertisement, etc., published or distributed for the purpose of selling securities in Class D shall contain the following words in bold-face type: "Securities in Class 'D' under Illinois Securities Law. These are speculative securities."

But it shall be unlawful to make any other reference to the fact that the provisions of the law have been complied with. Furthermore, all such advertising literature shall contain a statement of the assets, liabilities, income, and expenses of the issuer, the law under which the issuer was incorporated or organized, and the names and addresses of all officers, directors, and trustees of the company. A copy of such financial prospectus, etc., shall be filed in the office of the Secretary of State within ten days after the first circulation, publication, or distribution. It shall be unlawful to publish or circulate therewith a statement of the earnings of other companies engaged in a similar business.

Under a recent ruling by the Secretary of State, dealers may offer and provisionally sell all classes of securities *before* they have been accepted by the Secretary as properly qualified, actual delivery of the securities themselves not being made until after qualification.[1]

III. Penalties:

The penalties attached to the act are severe. Attempts to sell securities without full compliance with the provisions of the act

[1] The necessity and justice of this ruling are obvious. The process of qualification is often long, and if the dealers have to wait during this period before they can solicit purchases the securities will be moved to some other part of the country where they can find a quicker market; and profit that should normally accrue to the Illinois dealers will be lost to them.

are punishable, in the case of dealers, with fines as high as $10,000, or one year's imprisonment, or both; and for sale of securities in case the issuer is known to be insolvent, when the purchaser loses by such sale, $10,000, or five years, or both. In addition, dealers who sell in violation of any provision are liable for the full purchase price to the purchaser, plus reasonable attorney's fees; and for misrepresentation of the facts contained in the filed statements, to a maximum fine of $5,000, or one year's imprisonment, or both.

These are the more important provisions of the new law. In theory, it combines the principle of classification with an attempt to prevent the sale of securities that show evidence of fraud or misrepresentation. In practice, it appears to do little more than group securities, and to secure some measure of publicity for the grouping established. The actual effect of this publicity on the purchase of securities is very doubtful. According to the law, twenty-five copies of all statements, documents, etc., must be filed with the Secretary, and are theoretically accessible to the public; but in point of fact the investing class does not seem to be aware of this, and makes no attempt to use this information in passing judgment on issues. Moreover, it is only for Class D that a statement is required on advertisements and prospectuses, giving the state classification of the issue; and, as we shall show later, evasion of even this provision is easy. As to prohibition of sale, relatively few issues have been forbidden, perhaps because most of the questionable securities of the state never come up for judgment by the Secretary. The explanation of this fact also we shall discuss later.

The law has, at the time of writing, been in operation a little over seven months, but already—as was inevitable—various technical omissions and loopholes have been discovered in its structure.[1] They are being gradually remedied by administrative

[1] No legislative provision was made for stock which, although it had been issued and generally accepted prior to the passage of the law, and was thus really qualified for Class A, nevertheless was not listed on any exchange. Again, section 37 provides that any dealer who makes a sale in violation of any provision of the act shall be liable to the purchaser for the amount paid. This clause has already been used quite widely to blackmail dealers who by carelessness or inadvertence have technically broken the law.

action, however, and need not concern us further, although it is interesting to note that the number of groups provided for in the scheme of classification is already being found insufficient. Instead, we shall turn to a consideration of four more general questions: the actual effect of the law; the attitude of the public; constitutional difficulties; and the matter of a more adequate remedy for the securities problem as a whole.

First as to the actual effect of the law. This question divides itself into three parts: the control exercised over dealers and issuers; the effect on general industrial development; and finally the success of the law in preventing misrepresentation and fraud in the handling of securities. The positive, corrective control exerted by the law over issuers as such has probably been very slight, partly because it is primarily the dealer and not the issuer who must qualify; partly because evasion is comparatively easy, as we shall show presently; and partly because the law applies to only one state: the issuer can sell in the majority of other states with no particularly severe restrictions. On the other hand, the control maintained over perhaps the majority of dealers is almost too strict. The difficulty lies in the fact that the law regulates with great minuteness those reputable dealers who announce themselves and apply for qualification, whereas it provides absolutely no effective mechanism for compelling questionable dealers to qualify. It exactly inverts its supposed purpose; it burdens the class that is honest with endless red tape, and guards it carefully from law-breaking; while it calmly permits the more dubious classes to operate almost without hindrance.

It is perhaps too soon to pass judgment on its effect upon the development of new enterprises, but the first eight months of its operation show rather striking results. Of 364 applications to sell securities in Illinois 173, or nearly one-half, were refused.[1] Some of these refusals were probably made on technical grounds, and not all are final, but the large proportion is very significant: they cannot all have been made because of an intention to defraud.[2]

[1] From statement appearing in the daily press.

[2] The experience of Kansas is also illuminating: of 1,500 applications, hardly 400 were granted. See W. B. Hale, "The New Corporations Act and the Securities Law," *Illinois Law Review* (December, 1919), p. 368.

This at once raises the whole question of paternalism in government action. The Illinois law, like those in other states, gives to a public officer the right to decide what securities shall be sold within the state. A discussion of how far this is desirable as a general principle is not appropriate here, but two practical difficulties are at once manifest. First, no sort of standard is established for judging the merits of the applicant. The duty of the Secretary is to prevent fraud, but the only agent or guide given him is a general power of interpretation, and this power, even if constitutional, is obviously open to serious abuse. Second, the application of the principle seems to involve a new definition of fraud. Technically there is no fraud in offering for sale securities that no reputable banker would touch, if the nature of the offer is truthfully presented; but the actual administration of the Illinois law tends to impute fraud to *any* dangerous enterprise.[1] This constitutes an extension of paternalism to bounds previously unknown; and while it may be in the long run desirable, the immediate effect on industrial development has already been very marked.

The effect upon established banking and brokerage businesses has been even more pronounced, and in some directions rather disastrous. Because of the cumbrous red tape, expense, and delay involved, the law is operating to drive securities away from the Illinois markets, for the issuers find it far easier and more profitable either to handle their securities by mail, or else not to attempt any sales at all in Illinois. The writer has personal knowledge of a number of important cases where this has already taken place. Moreover, until the recent ruling, given in the summary at the end of the section on dealers, the law required the dealer to pay his fees and undergo the expenses of qualification before any sale could be made, and this frequently in the case of the smaller issues wiped out practically all profit. Because of this, and despite the new ruling, various large New York bankers have already shifted a considerable part of their western business to the eastern markets. Finally, the delays incident to qualification often make it impossible for the dealer to take advantage of a sudden favorable turn of the market. It should not be assumed from these statements that

[1] *Ibid.*, p. 369.

the law is having a disastrous result in Illinois, for many dealers and many classes of securities, especially the larger issues, are not injuriously affected; Class A and Class B securities are of course exempt from the law, and in so far as the dealer handles this type of investment alone, the law need not concern him. To those handling Class C and Class D securities, however, it is undoubtedly causing distinct losses both in time and in money.

The effect of the law in accomplishing its fundamental object, the prevention of misrepresentation and fraud, is, as we have already suggested, very doubtful. In the first place, if a fraudulent enterprise applies for qualification, the evidence upon which its application is judged is, primarily, its own sworn statements, which it can falsify at pleasure; and while the penalty for this perjury is severe, adequate machinery is nowhere provided for checking up on these statements. Second, of far more importance, the state has absolutely no means for insuring that *all* dealers in the state qualify their securities, or that they qualify everything they handle. The practical effect of the law on a dishonest dealer is little more than that it politely asks him to obey, without attempting to enforce the request. This applies with especial force to the handling of securities issued by "foreign" corporations—Texas oil stocks, for example. Finally, the two agencies by which doubtful securities are most commonly disposed of—direct correspondence and advertising—do not in practice come under its jurisdiction at all. In the one case the federal government exercises some control; and in the other, efforts have been made to enlist the Chicago newspapers against the acceptance of spurious advertisements; but the effect upon the general situation has not been great. We can therefore justly say that, whatever its intrinsic merits or demerits as a principle, the law is in fact a failure because it lacks teeth: it makes rules and establishes penalties, but neglects to provide for the comprehensive and vigorous enforcement of either. Capable administration is doing what it can to remedy this situation, but the fundamental difficulty is in the structure of the law itself.

The second question, which can be discussed very briefly, is that of the attitude of the public and of the various interests in

the state. The manufacturers and the business class as a whole have apparently paid little attention to it, not unnaturally, since for practical purposes it does not concern them very directly: most of the actual red tape is left to the dealers. The banking class, however, still bitterly resents the interference with its private affairs which the law, when applicable, entails. Moreover, in addition to this direct interference, it places well-known and reputable firms of many years' standing on precisely the same footing as the obscure promoter of a fly-by-night scheme, and obliges them, for each new issue, to go through precisely the same elaborate process to qualify themselves. There is of course a great deal of justification for the opposition of the bankers; but when analyzed it is found to center very largely around the difficulties involved in handling Class C securities; the bankers are the first to admit the desirability of regulations for the purely speculative group, Class D. It is almost certain that when the effect of the recent ruling[1] on Class C is fully understood, this hostility will disappear. There are three other questions, however, of more permanent difficulty, which it must suffice to indicate briefly. First, even the most honest promoters do not like to call their schemes "speculative," and their opposition to this clause has been great. Second, the proper classification of securities, apparently simple, has already caused a great deal of trouble. Finally, the complications in dealing with foreign corporations are numerous and puzzling. The rules governing them are obscure; there are many conflicts of jurisdiction; and the upshot, according to Hale,[2] is that "no corporation will desire to make sales of securities (in Classes C and D) under the provisions of this act if it can help it." So far as this is true, hostility on the part of the investing public is inevitable.

The third question is that of the constitutional aspects of the law. To date, the problem of personal rights, which might well have been serious, does not appear to have come up. In theory it is provided that an executive official shall pass upon each issue and

[1] The ruling of November 8, 1919, already referred to; it greatly simplifies the requirements for qualifying Class C securities.

[2] *Op. cit.*, p. 375.

give his consent before a sale can be made, and this would appear to be an infringement of the individual's right to buy and sell without restriction in the absence of fraud. As the law is actually administered, however, this difficulty has not appeared; the state officials have kept well inside the limits of the broad powers probably given them, and they do not try to prohibit the individual's acquiring a gold brick if he wishes, provided only that it is clearly labeled as such. Nevertheless, it is worth while to note other difficulties that may arise, and that have already been the subject of litigation in connection with somewhat similar laws in Ohio, South Dakota, and Michigan. These laws were charged with: (1) violating the commerce clause of the federal Constitution; (2) delegating legislative and judicial power to an executive official; (3) depriving citizens of liberty and property without due process of law. The district courts upheld these pleas, but the Supreme Court of the United States "with reference to the due process clause, has decided that it will not follow technical reasoning. It waived the objections and put the whole responsibility upon the legislatures of the states which passed the laws."[1] In a word, it refused to consider the impolicy of a government's legislation. The bearing of this decision on the Illinois law is obvious: it leaves the state virtually unhampered by constitutional considerations.

We now come to the last problem to be considered: the intrinsic merits of the method of attack represented by the Illinois law. Is this, after all, the right way to approach the problem? In this country, can any law succeed which confines itself primarily to the question of the sale of securities to the individual, after they have been issued? The Committee on Legislation of the Investment Bankers' Association has just published an interesting view of the question, as follows:[2] "To the present time such acts as have been passed and put into effect have been fundamentally wrong in the

[1] Hale, *op. cit.*, p. 372.

[2] Investment Bankers' Association of America, *Bulletin*, Vol. VIII, No. 8 (December 10, 1919), pp. 125–30.

way they sought to go about the solving of the problem. . . . . The theory of licensing reputable dealers in investment securities has proved to be worse than useless, in that reputable people do not need to be controlled, and . . . . a person already violating the law, and subject to criminal prosecution, [will] not be deterred from his ways by the placing of one more additional statute on the books." The report neglects to advance any very constructive program of amendment or reform, but it is in substantial accord with the criticisms we have already offered of the Illinois law: it burdens the honest dealer, in practice lets the questionable dealer go unscathed, and entirely misses the fields where misrepresentation and fraud are commonest and most injurious to the people. The writer is inclined to agree with the report just quoted in asserting that the Illinois law, like all the laws now on American statute books, attacks the problem from the wrong end. It attempts, primarily, to regulate securities *after* they have been issued and made ready for sale; whereas the only effective form of control must be that which is imposed *at the source*, and which actively governs, as none of our laws now do, both the actual issuing of the securities and the formation of the corporations themselves.

The drafting of a constructive plan of regulation is obviously beyond the scope of this paper, but it will perhaps be profitable to outline briefly the nature of the problem involved. On the one hand, we wish to prevent fraud and misrepresentation in the issue and sales of securities, and to exercise at least some control over the promotion of highly speculative schemes that are almost certain to involve the investor in heavy loss. On the other hand, we must avoid imposing any very severe burden, either on the further expansion of already extant industry, or on the development of new and legitimate enterprises. To phrase the question a little differently, will the nation lose more from the restriction on industrial development imposed by an effective system of regulation than it is now losing daily from the purchase of all the thousands of questionable and actually fraudulent securities that are flooding the markets? Stated in this way, the problem becomes an apparently simple one of dollars and cents, capable of easy solution; but

unfortunately no adequate figures are available. Nevertheless the national loss from the purchase of wildcat securities is undeniably very large, while it is at least possible, if not probable, that loss from regulation can be kept very small, and perhaps avoided entirely. Many will of course say that, no matter what the loss, questionable promotions should be given free rein, as being the only way to secure unchecked "legitimate" developments, as giving a desirable form of national discipline, and so on. But this policy means continuous loss to the one class which can least successfully endure losses—the small investor, especially widows and older people who have managed to save a little money; and this can hardly be made to appear a national benefit.

We then have two more immediate problems to solve. On the one hand, we must devise a plan that will shift the major part of the risk of starting and financing new enterprises to the classes which can best afford to bear that risk, namely, the larger private investors and capital-holders. On the other hand, we must make the profession of speculative promotion unprofitable, and preferably make it impossible for men to float new schemes, take their profits from the actual process of promotion, and then get out, leaving the enterprise to its own devices.

The value of these general aims, as aims, is probably not open to serious question. The real difficulty arises over the means to be adopted in achieving them. We cannot attempt any practical solution at this point, but three things are fairly obvious. First, some form of positive and determinative control, consistent with national industrial growth, is eminently desirable. Second, the basis of this control must be federal, in order to secure uniformity and to prevent the leaving of loopholes through variations in the laws of the several states. Finally, to be effective, it must be imposed at the source; it must embrace not only the sale and issue of securities but also the actual formation and early operation of the corporations themselves. In other words, it must act as a sort of winnowing machine, to sort out the good from the bad. The writer is well aware that at the present time, and especially to the business class, such a proposal will not be over-welcome; yet

the problem is a serious one, demanding a solution in the near future. Other forms of control have in this country failed miserably, and a new departure is clearly indicated.

NOTE.—The statements of fact made in this paper, except those actually quoted, are based on the results of various interviews secured by the writer with Illinois lawyers, investment bankers, and state officials of high rank and standing. For obvious reasons these authorities cannot be quoted verbatim; the local situation is still too unsettled to make full publicity desirable or even possible.

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